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Views and Debates

Towards a Property Rights Foundation for a Stakeholder Theory of the Firm

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Abstract. This research paper suggests that due to the changing nature of the firm in today's business world, viewing shareholders as the sole residual claimants is an increasingly tenuous description of the actual relationships among a firm's various stakeholders. Thus, a shareholder wealth perspective is increasingly unsatisfactory for the purpose of accurately answering the two fundamental questions concerning the theory of the firm: that of economic value creation, and the distribution of that economic value. *The thesis of the current paper is that examining the firm from a property rights perspective of incomplete contracting and implicit contracting provides a solid economic foundation for the revitalization of a stakeholder theory of the firm in strategic management and in expanding the resource-based theory of the firm.* In order to make progress in strategic management, a clearer conceptual and empirical understanding of implicit contracting is required. The perspective outlined in this research paper provides for a more accurate direction towards both measuring economic value creation, and analyzing the distribution of that value. It is also submitted that such a perspective has important implications for corporate governance, particularly when managers must balance the legitimate and conflicting claims among stakeholders to achieve the goal of enhancing economic value.

The two fundamental questions in the history of economic thought concern the theory of economic value and the theory of the distribution of this value (Schumpeter, 1954; Weintraub, 1977). These two persistently challenging questions are also – or, arguably should be – the two fundamental questions concerning the so-called "theory of the firm" as developed within industrial organization economics since the 1930s (*e.g.*, Coase, 1937), within corporate finance since the 1950s, and more recently within the discipline of strategic management. For the purpose of the current research paper, we largely focus on prospects for developing within the discipline of strategic management a new theoretical approach to address these two fundamental questions, one

which is based primarily on a *property rights foundation for a stakeholder theory of the firm*.

Seminal works in classical property rights literature include Alchian and Demsetz (1972), Coase (1960), and Demsetz (1967). The modern property rights approach, discussed in Hart (1995), builds on Grossman and Hart (1986) and Hart and Moore (1990). Whereas the modern property rights research literature equates ownership with residual control rights, classical property rights theory defines ownership as residual rights to income (residual claimancy). On the one hand, the appropriate allocation of residual control rights suggests mitigating *ex post* contractual problems, while on the other hand effectively aligning residual claims leads to mitigating *ex ante* contractual problems. *Both* residual claimancy and residual control (*ex ante* and *ex post* contractual) issues are at the heart of a definition of ownership. The strategic management research literature has begun to utilize and develop both the classical and modern property rights theory in recent years (e.g., Chi, 1994; Liebeskind, 1996; Miller and Shamsie, 1996; Argyres and Liebeskind, 1998; Oxley, 1999; Foss and Foss, 2001; Kim and Mahoney, 2005). However, the implications of property rights theory for stakeholder analysis are still at a nascent stage of development (Donaldson and Preston, 1995; Zingales, 2000; Thompson and Driver, 2002; Aguilera and Jackson, 2003; Aguilera and Cuervo-Cazurra, 2004; Grandori, 2004).

The strategic management discipline has made some conceptual and empirical progress in the past two decades on addressing the first of these two fundamental questions of economic value creation, although it has been primarily from a shareholder wealth perspective, rather than from a broader stakeholder perspective (Blair, 1995), which we espouse in this paper.[1] The second of these two fundamental questions of how the economic surplus generated by the firm is, or should be, allocated among the various *stakeholders*[2] has been given little research attention. The thesis of the current research paper is that in order to answer more precisely these two fundamental questions concerning economic value creation and the distribution of this economic value, a property rights theory of the firm from a stakeholder perspective must first be developed.

Development of a property rights theory of the firm should prove fruitful in moving forward the strategic management field's primary theory – i.e., resource-based theory (e.g., Penrose, 1959; Rumelt, 1984; Wernerfelt, 1984; Peteraf, 1993) – beyond a shareholder wealth perspective. This shareholder wealth perspective focuses on whether resources are valuable, rare, inimitable and non-substitutable (the so-called VRIN criteria) (Barney, 1991) for achieving sustainable competitive advantage (typically from a shareholder wealth perspective and the maximization of NPV, see Barney, 2002). Indeed, the VRIN criteria of valuable, rare, inimitable and non-substitutable of Barney (1991) bear some resemblance to the Hart and Moore (1990)

framework with its emphasis on economic value creation. The commonality of the property rights theory and the resource-based theory is that both theories rely on market frictions. An important difference is that the property rights theory is seeking a set of market frictions to explain the efficient boundary of the firm, while resource-based theory is seeking a set of market frictions to explain the firm achieving economic rents. We conjecture here that the set of market frictions to explain economic rents in resource-based theory will be a sufficient set of market frictions to explain the boundary of the firm (ownership) in property rights theory (see Mahoney, 2001).

In this research paper we emphasize that a stakeholder perspective indicates that it is no longer tenable to regard the shareholders as the only residual claimants, where residual claimants are defined as persons or collectives whose relationship to the firm gives rise to a significant residual interest in the firm's success or failure. Indeed, Stout forcefully argues that: "the residual claimants argument for shareholder primacy is a naked assertion, and an empirically incorrect one at that" (2002: 1193). Stout (2002) points out that the argument that shareholders are the sole residual claimants in corporations not only does not hold as a practical matter, but also as a matter of law. The idea that the law views shareholders as the sole residual claimants is a common misconception among many economists. Such a view is not legally accurate.

In the current paper we maintain that such a fundamental change in perspective is considered especially promising because a careful examination of the property rights research literature not only informs the determination of economic value creation, but also enables a fine-grained analysis of distributional conflicts (Libecap, 1989; Coff, 1999; Kim and Mahoney, 2002). In order to provide an economic theoretical foundation for stakeholder theory, we consider next property rights theory.

1. What are Property Rights?

The fact that multiple definitions have been attached to the single term 'property rights' has been a source of some confusion in the property rights literature. Some scholars, for example, consider a narrow definition of property rights in terms of legal recourse available to owners of property (either tangible or intangible) in the case of inappropriate actions by non-owners. More generally, property rights refer to *any* sanctioned behavioral relations among decision makers in the use of potentially valuable resources; such sanctioned behaviors allow people the right to use resources within the class of non-prohibited uses. This more inclusive definition of property rights is conceptually broad and emphasizes both the legal aspect of property rights *and* the social conventions that govern (business) behavior, such as corporate culture and reputation (North, 1990). Thus, in the current research paper,

property rights include any social institutions that define or delimit the range of privileges regarding specific resources granted to individuals. Private ownership of these resources may involve a variety of property rights including the right to exclude non-owners from access, the right to appropriate the stream of economic rents from use of and investments in the resource, and the right to sell or otherwise transfer the resources to others (Libecap, 1989). Conceptualizing property rights to have multiple dimensions has the important economic implication of many different people being able to hold *partitions* of rights to particular facets of a single resource.

According to Coase (1960), it is useful to think of resources as *the bundle of rights* rather than physical entities. Thus, from the property rights perspective, resources that a firm "owns" are not the physical resources but rather are the property rights. In the property rights approach the corporation is viewed as a "method of property tenure" (Berle and Means, 1932: 1). Utilizing such a property rights perspective of the firm, one can systematically examine each stakeholder in this "method of property tenure." For example, managers may have golden parachutes, stock options, and decision rights over organizational resources. Workers may have property rights concerning such factors as notification of layoffs, severance payments, or pension benefits.

Asset specificity is the source of potentially appropriable quasi-rents (Williamson, 1985), and property rights allocations are ways of governing the division of economic rents so as to avoid inefficient appropriation and under-investment. Since bundles of property rights can attenuate the problem of under-investment in firm-specific assets, they can be the source of potential economic value creation since investments in complementary assets are promoted (Teece, 1986; Mahoney, 1992). Specifically, property rights are the conduits upon which economic value of resources can be channeled to high yield uses. Thus, property rights theory complements resource-based and dynamic capabilities research (Mahoney and Pandian, 1992; Teece et al., 1997).

Currently, resource-based theory is lacking in at least two respects that can be remedied by property rights theory: (1) with few exceptions, resource-based theory has made little use of the property rights research literature in the business contexts of both positive externalities such as complementary and co-specialized resources (Teece, 1986; Helfat, 1997), and negative externalities, such as the lack of oil field unitization for migratory oil (Kim and Mahoney, 2002), and hence, business cases where property rights resources are not secure often fall outside of its analytical framework; and (2) the presence of a feedback loop with distribution issues impacting productive utilization of resources falls outside current resource-based theory. Extant property rights theory enables us to relax the implicit resource-based view assumption that property rights to resources are secure, and *thus take into*

account processes where there are struggles in establishing property rights that enhance the realized economic value of resources.

2. Why is a link between Property Rights- and Resource-Based-Theories of the Firm needed?

Since this property rights view has been expressed in the research literature for several decades, an explanation is required as to why a renewed interest in the property rights research literature in the field of strategic management is warranted. This research paper examines three reasons why a connection between a property-rights theory of the firm and the resource-based theory of the firm is now needed. First, changes in the (reconstructed) conceptualization of the firm is needed because the nature of the firm (in the world of management practice) is changing, especially in a business environment with increasing importance placed on intellectual property rights and knowledge-based resources and capabilities (Nelson and Winter, 1982; Itami and Roehl, 1987; March 1991; McEvily and Chakravarthy, 2002; Madsen et al., 2003). With the increasing relevance of intangible assets and knowledge-based capabilities, dealing effectively with potential property rights problems due to asymmetric information and distribution conflicts becomes increasingly important.

Intangible capital, especially capital embedded in a firm's social and human capital, generally requires different organizational structures from those used for tangible capital to address the exercise of property rights by the firm. In an economy with a well- developed legal system, it is unlikely that a firm will have problems exercising its property rights over its tangible property, its physical plants, and its equipment. Most legal systems are quite effective at addressing physical property disputes. The firm generally does not have the capability to retain the legal ownership of its intangible resources embodied in its employees – resources such as technical expertise, marketing know-how, or industry knowledge. Therefore, if an employee decides to leave a firm to join a competitor or to start up a new competing firm, the firm must develop alternatives to the legal system – or must develop detailed structures within the existing legal framework – when dealing with disputes involving these intangible resources,

A second reason for proposing new connections between property rights- and resource-based theories of the firm is that changes in the nature of the firm motivate a new conceptualization of the firm from which economic value creation emerges. For example, many (but by no means all) large conglomerate firms – the evolution of which in the 1920–1960 time period was extensively documented by Chandler (1962) – have been broken up, and some of the strategic business units have been spun off as stand-alone firms (Woo et al., 1992). Vertically integrated enterprises – the evolution of which in the 1840–1920 time period was extensively documented by Chandler (1977)

– have often moved toward vertical de-integration, and toward more decentralized forms for the purpose of achieving both more efficient tactical coordination and more effective strategic collaboration (Leiblein and Miller, 2003). Such substantive changes in the structures of corporations give rise for the need to reevaluate the tools and overall framework used to analyze these organizations.

Perhaps most importantly, business enterprises that historically could be usefully understood in large measure as leveraging physical resources to achieve both economies of scale and economies of scope (Chandler, 1990) are now becoming increasingly dominated by firm-specific human and organizational capital. For example, the 1990s wave of initial public offerings of purely human capital firms, and technology firms whose main resources are key employees, is challenging our understanding of the nature of the firm, where economically valuable human resources (Lado and Wilson, 1994) are often operating with commodity-like physical resources. Therefore, both human and organizational capital are now emerging as the most crucial organizational assets (Williamson, 1996), and such fundamental economic changes arguably call for changes in governance in terms of the constraints on management, compensation and/or board representation (O'Connor, 1993; Luoma and Goodstein, 1997; Hillman, Keim and Luce, 2001; Huse and Rindova, 2001).

It is worth noting here that if the defining dimension of the firm is that it substitutes authority for the price mechanism in determining how decisions are made (Coase, 1937; Williamson, 1985), what are the decision control rights of shareholders in a firm that consists of economically valuable human resources operating with commodity-like physical assets? In such a firm, should workers also be allocated decision control rights (Blair, 1995)? Such corporate governance issues can already be witnessed in medical practices, investment banks (especially "boutique" banks), law firms, and advertising firms (Zingales, 2000). Blair states that: "A knowledge company's primary resource and principal competitive advantage is the knowledge that its employees possess, which may or may not be captured in some form of intellectual property such as patented drugs, copyrighted books, or proprietary software. Where the critical resources are embodied in the employees and corporate boundaries are shifting rapidly, the traditional notion of remote and uninvolved shareholders as owners of corporations is an inherently unsuitable basis for thinking about how these institutions should be governed" (1995: 292).

Furthermore, along these lines, currently one of the more tangled thickets in corporate law concerns the proper interpretation of corporate constituency statutes at the state level, and the question of to whom, exactly, do the directors of the firm owe their fiduciary duty. Typically, these statutes require directors to consider the "best interests of the corporation" as a whole (Blair, 1995).

Indeed, consideration of distributional conflicts among stakeholders and the evolution of property rights are essential for a more complete strategic management (resource-based) theory of *realized* and not just potential economic value creation (Kim and Mahoney, 2002). As resource-based theory is extended to studying economic value creation in transitional economies and intellectual property (Takeyama, 1997), property rights theory will take on even greater managerial significance. Indeed, in the property rights perspective, where there are positive transaction costs, an important source of economic value creation stems from reduction of the dissipation of economic value in the exchange process (Libecap, 1989; North 1990; Barzel, 1997).

There is also another important sense in which resource-based theory and property rights theory are complementary: the more economically valuable the resources the more economic incentives there are to make property rights of such resources more precise, and the more precisely delineated the property rights of these resources, the more economically valuable resources become (Libecap, 1989; Mahoney, 1992). The process of making property rights of resources more precise can be another way of looking at the economic value creation process. Systems of property rights are, in essence, conduits upon which value-creating activities are implemented so that resources can be channeled to these higher-yield uses (Kim and Mahoney, 2002). We hasten to add that asymmetric information and distributional conflicts may limit resources from being channeled to these higher yield uses. Consideration of distributional conflicts and the (imperfect) evolution of property rights are essential for a more complete resource-based theory of (realized) economic value creation.

As a result of these fundamental economic changes (which typically alter underlying transaction costs), the boundaries of the firm are in constant flux and governance structure decisions can typically be anticipated to change the boundaries of the firm, and (perhaps less apparent) can consequently influence the outcomes for economic value creation and distribution among stakeholders. Indeed, to more fully understand and explain: "what is going on here?" Williamson (1996) requires that the strategic management discipline become informed beyond its current (implicit) intellectual focus (*e.g.*, by becoming more informed about rudimentary aspects of corporate law, and by analyzing more deeply the competitive structure of both strategic factor input markets and output markets).

A third reason for connecting property rights- and resource-based theories of the firm is the need to address more precisely the fundamental question of economic value in a business world where the economic maximization of a single residual claimant is becoming increasingly tenuous. The connections between the property rights theory of the firm and the economic value creation of the firm have not been made apparent even in contemporary

state-of-the-art strategy research literature. Such fundamental connections are important to make clear.

When the stakeholder perspective of the firm is considered, and the entire economic value created by the firm is of importance, one needs to consider the discounted sum of the economic payoffs generated by the firm minus the economic opportunity costs of the input resources used. However, a coherent theory of the economic value creation of the firm presupposes a definition of what a firm is, as well as an understanding of the prices paid in strategic factor markets for input resources, usually the opportunity costs of alternative uses of these resources.

It is not only shareholders and management who extract economic value from the firm beyond their opportunity costs. Unionized workers, for example, may receive economic compensation above their next-best alternative. The stakeholder perspective then requires that the *entire* economic value of the firm include the economic rent appropriation by union workers. More generally, in the case of collective action or small-numbers bargaining situations, the balance of bargaining power to extract economic value may reside in the hands of suppliers, customers, labor or other stakeholders, whose benefits beyond their opportunity costs should be taken into account in order to capture the firm's entire economic value-added. While, of course, such an approach is economically very sensible, this stakeholder perspective is clearly at odds with the traditional shareholder wealth approach used in most finance textbooks, which identifies the economic value of the firm as the value of all market claims outstanding.

Whether this financial shareholder wealth approach or the (older-style) strategic management stakeholder approach is justified depends on what theory of the firm we hold. Thus, the theory of the firm has important consequences for the theory of economic valuation, which is one of the two fundamental questions of the strategic management discipline, and is of enormous relevance to managerial practice. The theory of the firm has fundamental economic implications for understanding (and arguably in the long-run influencing) economic value creation and distribution. Towards this objective, we next consider more closely the modern property rights research literature.

3. Two Property Rights Perspectives

Here we consider two prominent theories of the firm from a property rights perspective. First, the theory of the firm as a nexus of explicit contracts (and complete contracting) is analyzed. Second, the theory of the firm as a nexus of explicit and implicit contacts (and incomplete contracting) is further developed.

The Firm as a Nexus of Explicit Contracts. Clearly, the currently dominant (agency) theory of corporate governance in strategic management – and a

conceptualization of the firm prevailing in corporate finance – can be traced to the seminal articles of Alchian and Demsetz (1972) and Jensen and Meckling (1976). This conceptualization defines the firm as a nexus of contracts. Sometimes this definition includes only explicit contracts and is typically studied from a (*ex ante*) complete contracting perspective (while allowing for asymmetric information and divergent goals between principal and agent). From the mathematical principal-agent model (Holmstrom, 1982), the only residual claimants are the shareholders and therefore shareholders warrant the control rights to make decisions. Thus, the economic basis for shareholders' supremacy is established.

Zingales (2000) comments, however, that to accept this conceptualization of the firm at face value, one has to take a very narrow view of contracts. In such a narrow view, shareholders are the only residual claimants. In fact, however, a firm's decisions influence the economic payoffs of many other members of the nexus, sometimes even to a greater extent than that of the shareholders. The claim that shareholders are the firm's only residual claimants fails to fit the economic facts in almost all real-world business circumstances (Pitelis, 2004). First, employees are important residual claimants especially when firm-specific human capital is involved. Second, creditors can be important residual claimants. Third, complex network relationships among industrial suppliers and customers produce interdependencies and lead to important residual gains and losses.

The academic economic counterpart to such a narrow view of the firm of shareholder supremacy is the conceptualization of the firm as a nexus of explicit contracts in a world of complete contracting. In such an agency model – especially in its more formal mathematical form – there are no residual rights of control, by definition, since the nexus of explicit contracts are posited to specify in advance all the future economic payoff-relevant contingencies.

We hasten to add here that the complete contracting approach is not necessary to defend the shareholder value maximization criterion for the firm. For example, one line of argument in favor of shareholder value maximization in a world of incomplete contracting is that shareholders have fewer contractual safeguards than other stakeholders (Williamson, 1985). Our response in the current research paper is that there will be cases where a combination of bounded rationality, potentially opportunistic behavior, uncertainty, firm-specific capital asset specificity and asymmetric information can lead to inadequate contractual safeguards for those other than the stockholders.

Another line of argument by Hansmann (1996) maintains that one advantage of involving only shareholders in corporate governance is that both corporate decision-making costs and managerial discretion will be reduced (Sternberg, 1996, 2000; Oswald, 1998; Jensen, 2001; Grandori, 2004).

Roe argues that: "a stakeholder measure of managerial accountability could leave managers so much discretion that managers could easily pursue their own agenda, one that might maximize neither shareholder, employee, consumer, nor national wealth, but only their own" (2001: 2065). In the current research paper, we accept the critique that there are potential problems in moving to a stakeholder perspective, including potential increased discretion on the part of management and potential increased costs of corporate decision making. We maintain, however, that there are potential benefits of moving towards the stakeholder view, which we highlight in the text. To balance these potential costs and benefits may require case-specific analysis: There may not be a single 'best' governance structure. Therefore, we are not arguing that we should abandon the shareholder as an important claimant, but rather we are arguing that we should at least allow the consideration of other claimants. In fact, there may be many cases (e.g., under the complete contracting assumption) where the results from a shareholder-only perspective will indeed coincide with the results from a stakeholder perspective. However, there will likely be many other cases where the results from the two perspectives will not coincide. Further, we hold open the *possibility* that the *ex post* and *ex ante* inefficiencies that flow from shareholder primacy may turn out to be worse than the increased agency costs that may occur using a stakeholder approach.

To be clear, here is the essence of why we suggest that there are fundamental advantages of developing strategic management theory more along the lines of property rights theory rather than maintaining the current hegemony of agency theory. In the mathematical formulation of the principal-agent model (e.g., Holmstrom, 1982), agency theorists have modified the "contingent claims contracting" approach to take into account asymmetric information. Such complete contracting solutions posited by agency theory are hardly satisfactory in the world of business experience where contracts are usually incomplete. Real-world business contracting is typically incomplete if for no other reason than bounded rationality (Simon, 1978; Williamson, 1985). Finessing the problem of bounded rationality and constructing a complete contracting "solution" is often not satisfactory, pragmatically speaking, in terms of being operational. Fundamentally, incomplete contracting occurs because making (*ex ante*) complete contingent claims contracting is too costly, if not outright impossible, to achieve.

The agency perspective (Jensen and Meckling, 1976; Holmstrom, 1982) posits that explicit complete contracting has to a superlative degree contractually protected (*ex ante*) all stakeholders, other than the shareholders, against any negative consequences resulting from the choices of managers representing the equity holders. Indeed, any potential negative economic consequences have already been anticipated and factored in by all other

stakeholders within the explicit contract. Therefore, the shareholders, as the only residual claimants, should be allocated decision rights.

Thus, the proper goal from the agency theory perspective – indeed, the typically assumed goal from an economic efficiency perspective within such an orthodox economic model – is for the firm to maximize shareholder wealth. Consequently, the fiduciary duty of the managers acting as an agent for the principals (i.e., the shareholders) is to maximize the stock price of the firm. The economic logic under the nexus of explicit contracting perspective is since (by definition under this perspective) the shareholders are the only ones who bear risks from discretionary decisions made, the firm should be governed to maximize shareholders' value by maximizing net present value (NPV) via, for example, the discounted cash flow approach.

With this explicit contracting framework as a foundation, the stock price has become the complete arbiter of social value and has been used exclusively as the way to evaluate the social consequences of decisions made by the firm, such as corporate investments, mergers & acquisitions, and other corporate events. Hence, a proliferation of event studies that use share price movement as the sole criterion in the evaluation of strategic corporate actions is evident not only in industrial organization economics and corporate finance, but also in the discipline of strategic management.

The Firm as a Nexus of Explicit and Implicit Contracts. Such a retrenchment from the stakeholder perspective, in our view, is a primary reason why the current state of theoretical development of the theory of the firm, the theory of economic valuation in its entirety, and the theory of the distribution of that economic valuation is poor. What to do? In answering this question we begin by noting that in recent years there has been developing within industrial organization economics and corporate finance a new conceptualization of the property rights theory of the firm, which considers both explicit and *implicit* contracting (Zingales, 2000; Baker et al., 2002). This seemingly minor change in premises has profound consequences for how we are to understand the theory of the firm, the economic valuation of the firm in its entirety, and the distribution of this economic value.

For example, when considering both explicit and implicit contracts when assessing the economic value generated by the firm, one needs to assess the economic surplus captured by all stakeholders. It is worth noting, for example, that Blair (1995) reports that accounting profits may represent less than 60 percent of the total economic rents and quasi-rents generated by U.S. corporate activities in 1993. The remainder of the economic rents went to employees as returns for specialized human capital. Blair (1995) goes on to argue that rarely do we consider this specialized human capital as one part of what the corporation as a whole should be trying to maximize. In fact, finance texts typically assume that the NPVs for all stakeholders (other than the shareholders) are zero in competitive strategic factor input markets.

Thus, by definition, maximizing NPV refers to maximizing the NPV exclusively in terms of shareholder value.

A more economically cogent stakeholder approach to economic valuation would be to discount the entire economic value generated by the firm. To move from a stockholder wealth evaluation to a stakeholder economic valuation, however, requires a theory of economic value distribution of how the economic surplus is divided among different stakeholders, be they financial claim-holders (e.g., holders of equity, debt or options issued by the firm) or non-financial ones (e.g., employees, key customers, and suppliers).

In short, the modern property rights theory of the firm (initiated by Grossman and Hart, 1986; Hart and Moore, 1990) will in the long-run, we believe, lead – to a consequence quite unintended by these property rights authors – towards a revitalization of a stakeholder theory of the firm.[3] Prospects for developing a solid economic foundation for a new stakeholder theory of the firm are quite promising in the next generation of strategic management research both because of its sufficient intellectual rigor and its superior relevance in dealing with real managerial problems.

In recent years, the firm has become understood as a nexus of both explicit and *implicit* contracts, which are understood from an *incomplete contracting* perspective (Hart and Moore, 1990; Aghion and Bolton, 1992; Baker et al., 2001). Thus, the firm is no longer simply the sum of its components readily available on the market but is rather a unique combination of potentially complementary and co-specialized assets that can possibly be worth more (or less) than the sum of its parts.

For example, consider a firm with the reputation for upholding the "implicit contract" of not expropriating "quasi-rents" that have been generated by employees investing in firm-specific human assets (Klein et al., 1978; Williamson, 1985). Or put differently, the firm has a credible policy of rewarding employees fairly on the basis of their economic contribution to the firm, regardless of how much lower the economic value of these specialized human skills would be compensated in the marketplace as the employees' next best option outside the firm. Relying on such a non-tradeable reputation (Dierickx and Cool, 1989), the employees can be anticipated to be willing to make firm-specific human capital investments that are greater than they would have been willing to make in the marketplace, where complete explicit contracting is not feasible. If such firm-specific human capital investments are indeed economically valuable, and could not have been elicited by explicit contracting, then the firm's non-tradeable reputation adds economic value and represents an organizational asset. Similarly, a subcontractor exploring for oil will buy site-specific new equipment only if there is a warranted belief that the contracting oil firm will not try to squeeze the subcontractor's economic rents once the subcontractor has made a sunk cost relationship-specific investment (Shleifer and Summers, 1988).

Indeed, it is worth noting that two challenges face managers in attempting to build and maintain a reputation for fair treatment of stakeholders in an implicit contract. First, the managers of the firm are subject to periodic shareholder vote, so that a future management team that does not share the current management stakeholder philosophy may replace the current management team. Second, managers that currently embrace the stakeholder focus may reconsider their approach if the firm faces financial difficulties; for example, the only way for the firm to survive an economic downturn may be to renege on promises embedded in previous implicit contracts. Therefore, even if a management team embraces the stakeholder approach, it could have difficulties ensuring that these 'time consistency' problems do not undermine their efforts.

To emphasize a point made earlier in the current paper: From an incomplete contracting theoretical perspective, other contracting parties besides the stockholders are not fully protected by explicit contracting, thereby undermining the foundational premise of shareholders' supremacy. The logic is that the combination of bounded rationality, opportunism, uncertainty, asset specificity and asymmetric information can make contractual safeguarding inadequate (Arrow, 1974; Williamson, 1996). Therefore, it logically follows in theory, and can be readily observed in the world of experience that unlike in the mathematical principal agent model, in the real-business world of incomplete contracting sometimes stakeholders will have their economic wealth unexpectedly expropriated (Shleifer and Summers, 1988). From this modern property rights perspective, Zingales inquires: "If many members of the nexus [of contracts] are residual claimants, why are shareholders necessarily the ones affected the most by the firms' decisions? Even if they are, are they the party that benefits the most from the additional protection granted by the control rights?" (2000: 1632).

Of course, once we admit that implicit contracts are part of the "nexus of contracts" then our conceptualization of the firm differs from its legal counterpart. Indeed, the firm may have implicit contracts with other stakeholders such as bondholders (Parrino and Weisbach, 1999), suppliers, and customers, among others.This implicit contracting view of the firm is far removed from the complete contracting approach.

Empirical research studies frequently focus on stakeholder issues in terms of the bottom line to shareholders (Waddock and Graves, 1997; Harrison and Freeman, 1999; Hillman and Keim, 2001). In this vein, there are many excellent research papers demonstrating the importance of including the customer as a stakeholder. For example, product recalls generate negative market returns (Davidson and Worrell, 1992); product innovations through R&D are generally shown to be positively associated with market stock price (Sougiannis, 1994); and improved customer satisfaction measures are found to be value relevant to shareholders (Ittner and Larcker, 1997). These empirical papers suggest an "instrumental approach" (Jones, 1995) in

which concern for other stakeholders are in the enlightened self-interest of shareholders. A particularly noteworthy empirical study found that because private information and associated relationship-specific activities are intrinsic to bank lending, borrowers incur significant economic costs in response to unanticipated reductions in bank durability (Slovin et al., 1993), and thus are stakeholders that indeed bear risk due to the actions of banks.

Once we recognize the existence of implicit contracts (and incomplete contracting), then other stakeholders besides the shareholders are residual claimants and these stakeholders may need to be protected. For example, the issue of incomplete contracts has also been addressed in the legal field. Ayres and Gertner (1989) discuss the distinction between immutable rules and default rules and the use of each to fill the gaps in incomplete contracts. It may be that some stakeholders would need to be protected through the establishment of immutable rules, particularly those who are not able to contract with the firm as they are either not part of the discussion (environmental concerns) or they are too disperse a group (consumers). Other groups, such as employees or suppliers, may be protected through the use of default rules, though the question still remains as to what form such default rules should take. An important consideration, we would argue, is that the default rules should be designed to minimize transaction costs.

It is now not clear whether decision rights should reside exclusively with shareholders, because the unfettered pursuit of shareholders' value maximization may lead to inefficient strategic actions, such as the breach of valuable implicit contracts. While in theory such discretionary financial contracting can be desirable (Ayres and Gertner, 1989; Boot, Greenbaum and Thakor, 1993), it is often troublesome when carefully scrutinized in real-world business practice (Shleifer and Summers, 1988). For instance, hostile takeovers sometimes result in the takeover firms terminating defined benefit pension funds mid-stream to enable economic transfers from workers to shareholders (Shleifer and Summers, 1988). Pontiff et al. (1990), in their sample of 413 takeovers, find that pension funds were reverted by 15.1% of acquirers in the two years following hostile takeovers compared to 8.4% in the two years following friendly takeovers. Further, reversions tended to occur when the potential for wealth transfer was the greatest. These empirical results are consistent with the view that hostile takeovers sometimes do (and may in some cases well be primarily intended to) breach implicit contracts between firms and employees. Economic efficiency losses will occur because stakeholders who anticipate opportunistic behavior will be reluctant to enter into implicit contracts with the firm (see also, Ippolito and James, 1992).

Moreover, the presence of implicit contracts makes it impossible to identify precisely the entire economic value created by the firm. As a result, stock price changes are not reliable arbiters of social welfare changes even when financial markets are perfectly (strong-form) efficient (Mahoney and

Mahoney, 1993; Demski, 2003). Therefore, we should not draw social welfare conclusions from event study analysis that incorporates only share price reactions to informative events.

4. Suggestions for Possible Research Agendas

In terms of further development of the stakeholder perspective, we believe that the distinction offered by Berman et al. (1999) between an ''instrumental approach'' (McGuire et al., 1988; Bowen et al., 1995; Greenley and Foxall, 1997; Ogden and Watson, 1999) – in which concern for other stakeholders is in the enlightened self interest of shareholders – and an ''intrinsic commitment'' view – concern for stakeholders as ends and not merely as means (Donaldson and Dunfee, 1994; Meznar, Nigh and Kwok, 1994; Blair, 1998; Agle et al., 1999) – has much to offer. In this regard, it is worth pointing out that a more fine-grained and potentially useful classification has been offered by Donaldson and Preston (1995), which offers three interrelated but distinct aspects of the stakeholder theory: *descriptive accuracy* (does the theory describe or explain characteristics or behaviors observed in the world of experience?), *instrumental power* (can the theory be used to identify connections between stakeholder analysis and traditional corporate objectives?), and *normative validity* (can the theory be used to guide managers in the moral or philosophical decisions to be made in the corporation?).

While the current research paper focuses primarily on an instrumental approach to stakeholder theory, developing research along the lines of intrinsic commitment to the stakeholder view also looks promising (Donaldson, 1999). We fail to see why advocating the maximization of the entire economic value is labeled as merely a value judgment, while advocating the maximization of shareholder wealth is rarely labeled so. In fact, a minimum ethical standard of holding to the desirability of Pareto improving strategic moves would support the maximization of the entire economic value (and appropriate side-payments could then, in theory, be distributed).

The current paper makes the case for the stakeholder perspective from an instrumentalist approach. However, a well-developed theory of justice (Rawls, 1971) needs to be applied to the second fundamental question of the distribution of economic value among various stakeholders. One cannot sidestep the fact that stakeholder theory will require value judgments and dialogue about the purpose of the corporation. As Andrews noted: ''Coming to terms with the morality of choice may be the most strenuous undertaking in strategic decision'' (1980: 89). Similarly, Barnard (1938) – a seminal management book providing the foundations for a stakeholder theory of the firm – maintains that executive leadership requires the personal capacity for affirming decisions that lend quality and morality to the coordination of organized activity and to the formulation of purpose.

Ansoff (1965: 35–36) noted that the Carnegie School's *Behavioral Theory of the Firm* (Cyert and March, 1963), which emphasized firm-level objectives derived from a negotiated outcome by subgroups, has much in common with stakeholder theory. Moreover, the "inducements-contributions model" of Barnard (1938) and Simon (1952) in which each participant (*e.g.*, entrepreneur, employee, customer) is offered an *inducement* (*e.g.*, revenue from sales, wages, goods and services) for participation in the organization and in turn makes a *contribution* to the organization (*e.g.*, costs of production, labor, purchase price) was an early seminal research framework from the stakeholder perspective (see Mahoney, 2005). Miller (1992), after a thorough analysis of agency theory (Jensen and Meckling, 1976), property rights theory (Grossman and Hart 1986), and institutional leadership (Barnard, 1938), concludes that a manager's task of inspiring "sacrifice" (from the institutional leadership perspective) may be as, or even more critical, than manipulating the economic incentives (which are emphasized in the agency theory and property rights theory approaches).

Along these institutional lines, in addition to highly influencing the Carnegie School (Simon, 1947; March and Simon, 1958; Cyert and March, 1963), Barnard (1938) also influenced Selznick (1957). Selznick (1957: 138–139) writes that: This process of becoming infused with value is part of what is meant by institutionalization. As this occurs, *organization management* becomes *institutionalized leadership*. The latter's main responsibility is not so much technical administrative management as the maintenance of institutional integrity ... The building of integrity is part of what we have called the "institutional embodiment of purpose" and its protection is a major function of leadership.

If one is convinced that property rights systems are conduits through which resources can be channeled to their highest-valued uses, several empirical implications emerge. Countries in which the legal regimes of property rights are more poorly protected will find it harder to attract financial capital or develop specialized human capital (North, 1990). Furthermore, within a given legal regime, industries that rely on resources that have attributes that are inherently more difficult to specify completely (*ex ante*) in a standardized contract (e.g., it may be more difficult to contract on intellectual or creative outputs than on commodity-like outputs), will find it necessary to develop relational contracts between the firm and the specialized resources. Within an industry, firms that are innovators in specialized relational contracts will be able to attract financial capital and will be better positioned to outperform their non-innovating rivals in terms of sales growth or return on assets.

Even within countries with well-developed legal regimes, changes over time may be suggestive of the importance of better-defined property rights. In the United States, for example, the movement away from defined benefit

pension funds towards defined contribution pension funds may have been motivated in part by the fact that defined contribution pension funds have better defined property rights over the economic value that the pension fund participants will receive when they retire. Conceptually, the firm has a greater capacity than the pension plan participant to bear the investment risk associated with pension assets. However, as Shleifer and Summers (1988) argue, (*ex ante*) risk sharing between the firm and the participants can become opportunistic (*ex post*) risk shifting because the (legally enforceable) property rights held by the pension fund beneficiaries are, in general, poorly defined.

The study of lease contracts could potentially provide a window into the world of implicit versus explicit contracts. Consider, for example, vendor-financing terms. Vendor financing occurs when the manufacturer of a product helps the buyer find funding to purchase the product. As the asset becomes more specialized, the contract becomes more explicit about contingencies – often the manufacturer or its financing arm becomes the depository of information regarding the primary sale and the resale markets for the product. Medical equipment leases, for example, provide for the termination of the lease if a better technology comes along, which is much different from the conditions of leases for less specialized assets, such as automobiles. In addition, a close study of the various contingencies in more specialized assets such as medical equipment, software, or commercial airliners, may bring a heightened understanding of the complexities of assigning property rights in industries with innovation paths that are hard-to-predict, and where the study of incomplete contracting, and implicit contracting have clear relevance in the discipline of strategic management.

A solid understanding of property rights from a stakeholder approach sheds light on well documented but poorly understood strategic management decisions and processes. For example, the Saturn car division of General Motors' original mission, governance structure, and internal processes fit the key criteria of a stakeholder firm. Employees establish themselves as influential stakeholders who contribute to problem solving, conflict resolution, and quality improvement (Kochan and Rubenstein, 2000). Saturn emerged as a stakeholder firm because the company and union leaders who shared power jointly, decided to create and develop an organization that would utilize workers' skills and knowledge and that would provide employees with a voice in the governance process.

5. Conclusions

In the current paper, we note that the research governance literature in strategic management over the past two decades has been dominated by agency theory and its conceptualization of the firm as a nexus of complete

explicit contracting. While the past twenty years in the discipline of strategic management have clearly witnessed a vast improvement in the scientific rigor within the research journal publications in strategic management, we argue here that such rigor has come at a high price in terms of managerial relevance.

Our main point here is that it is far superior to have a reasonably accurate understanding of the right (stakeholder) issues in the discipline of strategic management than rigorous and perhaps even precise answers to less relevant or contrived (shareholder wealth) questions. Indeed, scholars from the complete contracting approach (which essentially suppresses economic problems stemming from bounded rationality and limited information processing) often finesse the really difficult stakeholder questions that managers typically face.

The intellectual heritage of the discipline of strategic management owes much to what used to be called business policy (e.g., Ansoff, 1965; Andrews, 1971). This early business policy (and typically case study) perspective was unabashedly dedicated to a stakeholder perspective – which made the subject of management within the business school truly differentiated from the stockholder wealth perspective of industrial organization economics and corporate finance.[4] However, in recent years, the discipline of strategic management, perhaps due in part to the pursuit of greater academic standing and scientific legitimacy, has significantly retrenched from the stakeholder perspective (both in research journals and major textbooks) and has gravitated toward the shareholder wealth perspective, where stock price data are readily available.

We argue that the modern property rights perspective of incomplete contracting and implicit contracting provides a solid economic foundation for the revitalization of a stakeholder theory of the firm in strategic management. In order to make progress in strategic management an improved (conceptual and empirical) understanding of implicit contracting is needed. Currently, a firm's assets are certainly understated by the economic value of the implicit contracts with a firm's employees, when valuable firm-specific human capital is excluded from the balance sheet (DeAngelo, 1982). The same can be said for the economic value that other stakeholders bring, or the loss in economic value these stakeholders suffer when decisions are made strictly on the basis of shareholder value. For example, financial distress can create a tendency for the firm to take actions that are harmful to debt-holders and other non-financial stakeholders (Cornell and Shapiro, 1987; Baden-Fuller, 1989; Jog, Kotlyar and Tate, 1993; Opler and Titman, 1994). If the goal is to maximize total economic value, and this value is to be allocated among those contributing to/gaining from this economic value, then one needs a property rights stakeholder theory, which recognizes the role each of these groups plays in the creation and distribution of that economic value.

Notes

[1] In 1932, two preeminent corporate scholars published a debate concerning the proper purpose of the public corporation in the *Harvard Law Review*. Berle (1931) argued for what is now called "shareholder primacy" – the view that the corporation exists for shareholder wealth maximization. Dodd (1932) argued for what is now called the "stakeholder approach" – the view that the proper purpose of the corporation also included more secure jobs for employees, better quality products for consumers, and greater contributions to the welfare of the community. Stout (2002) provides an insightful analysis of the intellectual progress made over the years concerning the Berle-Dodd debate. For example, the argument that even the single controlling stockholder "owns" the firm is questionable. As Black and Scholes (1973) make clear, once the firm has issued debt (as almost all firms do), it makes just as much sense to say the debt-holders "own" the right to the corporation's cash flow but have sold a call option to the shareholder, as it does to say that the shareholder "owns" the rights to the corporation's cash flow but has bought a put option from the debt-holders. Financial options analysis clarifies that bondholders and equity shareholders each share contingent control and bear residual risk in firms. Blair and Stout (1999), along the lines of Rajan and Zingales (2001), go beyond the team production model of Alchian and Demsetz (1972) by considering that numerous corporate stakeholders may make firm-specific investments and that a "mediating hierarchy solution" requires team members, in their own self interests, to give up important property rights to a legal entity created by the act of incorporation. Thus, corporate assets are "owned" not by the shareholders, but by t*he corporation itself* and the board of directors should not be under direct control of either shareholders *or* stakeholders, providing a theory that is consistent with the way that many directors have historically described their own roles and is consistent with the law itself with directors acting as trustees to do what is best for "the firm." In this mediating hierarchy model of the modern corporation, the firm is frequently not so much a "nexus of contracts" as a "nexus of firm-specific investments" (Blair and Stout, 1999).

[2] There are numerous definitions of stakeholders in the governance research literature, based in part on the economic salience of these stakeholders (Aoki, 1984, 2001; Carroll, 1989; Preston, 1990; Hill and Jones, 1992; Hosseni and Brenner, 1992; Logsdon and Yuthas, 1997; Mitchell, Agle and Wood, 1997; Rowley, 1997; Clarke, 1998; Lowendahl and Revang, 1998; Scholes and Clutterback, 1998; Wheeler and Sillanpea, 1998; Frooman, 1999; Gioia, 1999; Jones and Wicks, 1999; Shankman, 1999; Trevino and Weaver, 1999; Scott and Lane, 2000; Charreaux and Desbrieres, 2001; Jawahar and McLaughlin, 2001; McWilliams and Siegel, 2001; Winn and Keller, 2001; Friedman and Miles, 2002; Kassinis and Vafeas, 2002; Mahon, 2002; Orts and Strudler, 2002; Windsor, 2002; Kaler, 2003; Phillips et al., 2003; Ryan and Schneider, 2003; Brammer and Millington, 2004; McLaren, 2004). For the purposes of this research paper we define stakeholders broadly as those persons and groups who either voluntarily or involuntarily become exposed to risk from the activities of a firm (Clarkson, 1995). Thus, stakeholders include shareholders (preferred and common), holders of options issued by the firm, debt holders (Parrino and Weisbach, 1999), (banks, secured debt holders, unsecured debt holders), employees (especially those investing firm-specific human capital) (Blair, 1996; Child and Rodrigues, 2004), local communities (e.g., charities) (Morris et al., 1990), environment as "latent" stakeholders (e.g., pollution) (Barth and McNichols, 1994; Henriques and Sadorsky, 1999; Phillips and Reichart, 2000; Buysse and Verbeke, 2003; Driscoll and Starik, 2004), the government (as tax collector) (Brouthers and Bamossy, 1997; Buchholz and Rosenthal, 2004), customers and suppliers (Freeman and Reed, 1983; Freeman, 1984; Freeman and Evan, 1990; Freeman and Liedtka, 1997). These stakeholders often gain substantially when the firm does well and suffer economic losses when the firm does poorly. Bowman and Useem state that: "To

exclude labor and other stakeholders from the governance picture ... is theoretically tidy and empirically foolhardy" (1995: 34).

[3] Interestingly, some have reinterpreted the modern property rights theory of the firm of Grossman and Hart (1986) and Hart and Moore (1990) – the GHM model – to support the shareholders' wealth maximization approach (Shleifer and Vishny, 1997). However, such an interpretation misses the key point of the modern property rights approach that it might be efficient to allocate formal control rights to the stakeholder who has a lot of de facto power, as is the case for key workers who can easily leave (Blair, 1995; Zingales, 2000). These alternative views support Donaldson and Preston's astute commentary that: "The theory of property rights, which is commonly supposed to support the shareholder theory of the firm, in its modern and pluralistic form supports the stakeholder theory of the firm instead" (1995: 88). Boatright (2002) draws a similar conclusion and provides the provocative commentary that: "The present system of corporate governance appears to sanction, indeed mandate, that managers externalize [externality] costs wherever possible" (2001: 1849). Holmstrom (1999) provides a mathematical model with distinctive features from that of the GHM model. In this model, the firm is viewed as a sub-economy in which the top management team has the decision rights to regulate trade by assigning tasks, delegating authority, and delineating principles for how explicit and implicit contracts are to be structured. Kim and Mahoney (2005) list over 40 published papers that extend and/or critique the GHM model, with Holmstrom (1999) being a prominent example. It should be noted that modern property rights theory supports a narrow, rather than a broad, definition of stakeholders emphasizing those who make critical firm-specific capital investments (Blair, 1995; Hart, 1995). We thank Anna Grandori for bringing this important theoretical point to our attention.

[4] At the beginning of the current paper, we noted that Berle (1931) was a major proponent of the shareholder primacy view of the corporation. Berle (1954) offered the following account of the Berle-Dodd debate concerning the shareholder supremacy versus stakeholder approach: "Twenty years ago the writer had a controversy with the late Professor E. Merrick Dodd of the Harvard Law School, the writer holding that corporate powers were powers in trust for shareholders while Professor Dodd argued that these powers were held in trust for the entire community. The argument has been settled (at least for the time being) squarely in favor of Professor Dodd's contention" (1954: 169). Blair and Stout (1999) note that Berle's (1954) retreat is supported by a series of mid- and late-twentieth-century cases that have allowed directors' decisions to sacrifice shareholders' profits to stakeholders' interests when necessary for the best interest of "the corporation." Case law interpreting the "business judgment rule" often explicitly authorizes directors to sacrifice shareholders interests to protect other stakeholders. Stout comments that: "Half a century after Berle's concession, academics continue to argue the merits of the [shareholder primacy] versus the [stakeholder] model of the firm. The business world continues to prefer the [stakeholder] model of the firm" (2002: 1209).

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